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January 3, 1994

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
Room 222
1919 M Street, N.W.
Washington, D.C. 20554

Re: National Exchange Carrier
Association, Inc.

Proposed Revision of Part 69 of the
Commission's Rules to Allow for
Incentive Settlement Options for
NECA Pool Companies

RM 8389

Dear Mr. Caton:

Enclosed herewith for filing with the Commission are the original and four copies of the National Exchange Carrier Association, Inc.'s Reply in the above-captioned matter.

Please acknowledge receipt hereof by affixing a notation on the duplicate copy of this letter furnished herewith for such purposes and remitting same to bearer.

Very truly yours,

Joanne S. Bochis
Joanne S. Bochis

JSB/bas
Enclosures

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

**National Exchange Carrier
Association, Inc.
100 South Jefferson Road
Whippany, New Jersey**

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TABLE OF CONTENTS

SUMMARY	ii
I. BACKGROUND	2
II. DISCUSSION	6
A. NECA's Reliance Upon OIR and Small Company Regulations as its Models for Optional Pool Regulatory Incentives Ensures Regulatory Symmetry, Fairness, and Efficiency.	6
B. NECA's Profit Sharing Plan Satisfies the Commission's Goals For Incentive Regulation.	8
1. NECA's Profit Sharing Mechanism is Reasonable.	8
a. Incentive Benefits Correctly Flow to Interexchange Carriers.	8
b. Inter-incentive Company Profit Sharing is Equivalent to OIR Provisions and Properly Balances Risks and Rewards.	9
2. NECA's Proposal Motivates Participants to Stimulate Access Demand.	12
3. NECA's Reliance on the Commission's OIR Plan Model Deters Companies From Improper Use of Regulatory Incentives.	12
III. CONCLUSION	13

SUMMARY

In response to the Commission's Regulatory Reform Order, NECA filed a Petition for Rulemaking proposing rule revisions to allow it to offer incentive settlement options within the NECA pools. NECA modeled these optional settlement alternatives for NECA pool members after recent Commission-adopted regulatory incentives for non-Association tariff participants.

As NECA described in its Petition, the proposal would offer NECA pool participants two incentive settlement options that allow continued pool membership, the "Pool Profit Sharing Incentive Option" and the "Pool Small Company Incentive Option." The first incentive option is one which would allow NECA pool study areas to settle with the pools based on formulas that resemble the Optional Incentive Regulation (OIR) Plan. The second, a simpler small company option, allows features similar to those found in Section 61.39 of the Commission's rules to be available only to Subset III study areas with fewer than 50,000 lines. Both proposed pool incentive options have attributes of average schedule formulas. NECA also proposed streamlined new services introduction, pricing flexibility and administrative rule revisions for the Pool.

The record strongly supports adoption of NECA's proposed settlement options, and favors granting NECA's proposals for streamlined new service offering tariff procedures, and OIR-type revenue-neutral pricing flexibility. Most commenters agree that NECA's optional incentive plans help fulfill the Commission's goal

to provide regulatory reform to small and mid-sized exchange carriers.

In its Reply, NECA shows that its proposals mirror current incentive plans that have been reviewed and adopted by the Commission. As such, they should neither tax Commission resources nor be unfamiliar to interexchange carriers. Further, NECA demonstrates that its profit sharing proposal produces the same incentives as the currently effective OIR plan. NECA's settlement options have the same safeguards against improper use; include a profit sharing mechanism that parallels the OIR plan; and motivate participants to produce greater efficiencies and stimulate access demand.

NECA's pool incentive proposals meet the Commission's goal to extend incentive regulation options to small and mid-sized telephone companies. NECA urges the Commission to adopt NECA's rule revisions as proposed.

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of

The National Exchange
Carrier Association Inc.
Proposed Revision of
Part 69 of the
Commission's Rules to
Allow for Incentive
Settlement Options for
NECA Pool Companies

RM 8389

REPLY

The National Exchange Carrier Association, Inc. (NECA)¹ submits its Reply in response to comments submitted in accordance with the Commission's November 16, 1993 Public Notice.² This Public Notice invited comments on NECA's Petition for Rulemaking to revise Part 69 of the Commission's rules to allow for incentive settlement options for NECA pool companies.³

¹ NECA is a not-for-profit, membership association, serving over 1400 local exchange carrier (LEC) study areas. NECA members include all local exchange carriers in the United States, Puerto Rico and the U. S. Virgin Islands.

² Comments Invited on NECA's Petition for a Revision of the Rules to Allow for Incentive Settlement Options for NECA Pool Companies, RM 8389, Public Notice, Report No. 1986, Associate Managing Director Public Information and Reference Services Petitions for Rulemaking Filed, released November 16, 1993. (Public Notice).

³ The NECA Proposed Revision of Part 69 of the Commission's Rules to Allow for Incentive Settlement Options for NECA Pool Companies, RM 8389, Petition for Rulemaking, filed November 5, 1993. (NECA Petition).

I. BACKGROUND

On November 5, 1993, responding to the Commission's encouragement in its Regulatory Reform Order,⁴ NECA proposed rule revisions to allow it to offer incentive settlement options within the NECA pools. These optional settlement alternatives are designed to provide incentives to small and mid-size NECA pool members similar to those recently adopted by the Commission for non-Association tariff participants.

As NECA described in its Petition, the proposal would offer NECA pool participants two incentive settlement options that allow continued pool membership, the "Pool Profit Sharing Incentive Option" and the "Pool Small Company Incentive Option." The first incentive option is one which would allow NECA pool study areas to settle with the pools based on formulas that resemble the Optional Incentive Regulation (OIR) Plan.⁵ The second, a simpler small company option, allows features similar to those found in Section 61.39 of the Commission's rules to be available only to Subset III

⁴ See Regulatory Reform for Local Exchange Carriers Subject to Rate of Return Regulation, CC Docket No. 92-135, Report and Order, 8 FCC Rod 4545 (1993) (Regulatory Reform Order). In that proceeding the Commission stated:

. . . we encourage NECA to continue to work on reforms to introduce optional incentive plans into the pooling process, which would be considered in the context of a separate proceeding, a waiver petition or a rulemaking (Id. at 4562).

⁵ See NECA Petition at 8-10 and 47 C.F.R. § 61.50.

study areas with fewer than 50,000 lines.⁶ Both proposed pool incentive options have attributes of average schedule formulas. NECA also proposed streamlined new services introduction, pricing flexibility and administrative rule revisions for the Pool.⁷

In response to the Commission's Public Notice, eleven parties filed comments. Commenters strongly support NECA's proposed settlement options.⁸ Commenters note that the settlement options are a good response to the Commission's request for incentive options for pooled services,⁹ and supports the Commission's effort to provide regulatory reform to small and mid-sized exchange carriers.¹⁰ In addition, parties praised NECA's proposed extension of regulatory incentive benefits to ECs other than those who have exited the NECA pools,¹¹ and endorsed NECA's proposal because it would afford NECA pool members the opportunity to adopt an

⁶ See NECA Petition at 11-12 and 47 C.F.R. §§ 61.39 and 69.3(f).

⁷ See NECA Petition at 12-16.

⁸ See, e.g., United States Telephone Association (USTA) at 1, Century Telephone Enterprises, Inc. (Century) at 1, John Stauriakis, Inc. (JSI) at 2, Puerto Rico Telephone Company (PRTC) at 1, The Organization for the Protection and Advancement of Small Telephone Companies (OPASTCO) at 4, Cathey, Hutton, & Associates, Inc. (CHA) at 2, Union Telephone Company (Union) at 2, PTI Communications (PTIC) at 2, and The National Telephone Cooperative Association (NTCA) at 1.

⁹ See, e.g., PTIC at 2.

¹⁰ USTA at 1, citing Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-3134, Second Report and Order, 5 FCC Rod 6786, 6827 (1990).

¹¹ See, e.g., USTA at 2, Century at 1, JSI at 2, and NTCA at 1 and 2.

incentive regulation plan, while maintaining the efficiencies inherent in pool membership.¹²

Parties supported the Pool Profit Sharing Incentive Option as it will provide benefits to the Commission, to pool tariff customers and to pooling companies.¹³ Moreover, NECA's Pool Profit Sharing Incentive Option would encourage efficiency by rewarding companies that reduce costs and stimulate demand on their networks.¹⁴ Commenters point out that promotion of efficiency through the proposed means would permit lower rates for customers in the future,¹⁵ and would balance the risks to individual study areas.¹⁶ Thus, commenters agree that NECA's profit sharing proposal would meet the Commission's objective of promoting efficiency under incentive regulation.¹⁷

Likewise, the record favors granting NECA's proposals for streamlined new service offering tariff procedures, and OIR-type revenue-neutral pricing flexibility.¹⁸ Parties strongly support streamlined tariff procedures for new service offerings that give small and rural NECA pool ECs the opportunity to serve their

¹² See, e.g., OPASTCO at 3, CHA at 2, NTCA at 2 and Union at 1.

¹³ PRTC at 2, Union at 2 and USTA at 3.

¹⁴ Century at 2 and USTA at 3.

¹⁵ PRTC at 1 and 2 and USTA at 3.

¹⁶ CHA at 2, OPASTCO at 3, PTIC at 1-2 and USTA at 3.

¹⁷ Century at 2, PRTC at 4 and USTA at 3.

¹⁸ See, e.g., NTCA at 5, PTIC at 2, CHA at 2, OPASTCO at 4, PRTC at 1 and 5-6, JSI at 3 and USTA at 3.

customers better,¹⁹ by simplifying and expediting the introduction of new services,²⁰ and by giving rural ECs the same opportunities as their urban neighbors.²¹ NECA's proposal for pricing flexibility, commenters assert, is required to allow NECA pool ECs to be more responsive to customer needs.²²

AT&T supports the "principle" of incentive regulation but wants to defer NECA's plan.²³ AT&T gives three reasons for the deferral: first, the Commission should devote its "finite" resources to access reform; second, NECA's plan relies on the OIR model which has an unproven track record for promoting EC efficiency; and, third, NECA's proposal does not meet the Commission's goals for incentive regulation to "stimulate LEC efficiency or encourage efficient non-discriminatory access pricing."²⁴

NCI raises concerns regarding commitment periods, profit sharing, identification and allocation of exogenous cost changes, and measurement of earnings and recommends that changes be made to NECA's proposal to address these issues.²⁵

¹⁹ OPASTCO at 4.

²⁰ PRTC at 5-6.

²¹ USTA at 3.

²² See, e.g. Century at 2 and JSI at 3.

²³ AT&T at 1.

²⁴ Id. at 1-2, 4 and 6.

²⁵ NCI at 2-9.

In this Reply, NECA will show that its proposals mirror current incentive plans that have been reviewed and adopted by the Commission. As such, these settlement options should neither tax Commission resources nor be unfamiliar to interexchange carriers. Further, NECA demonstrates that its profit sharing proposal produces the same incentives as the currently effective OIR plan. NECA's settlement options have the same safeguards against improper use of incentive plans; include a profit sharing mechanism that parallels the OIR plan; and motivate participants to produce greater efficiencies and stimulate access demand. Therefore, the Commission should adopt these plans as originally proposed.

II. DISCUSSION

A. NECA's Reliance Upon OIR and Small Company Regulations as its Models for National Local Exchange Incentives Ensures Regulatory Symmetry, Fairness, and Efficiency.

AT&T's argument that the Commission should devote its "finite" resources to access reform is without merit and fails to acknowledge the efficiencies to be obtained through NECA's reliance on existing incentive regulation. By using the Commission's OIR and small company regulations as models, NECA provides a framework with which the Commission and other commenters are already familiar. The OIR Plan and regulations for small company tariffs have been reviewed thoroughly by the Commission.²⁶ Therefore,

²⁶ See Regulatory Reform for Local Exchange Carriers Subject to Rate of Return Regulation, CC Docket No. 92-135, Notice of Proposed Rulemaking, 7 FCC Rod 5023 (1992); Erratum, 7 FCC Rod 5501 (1992) (Regulatory Reform NPRM). See also, Regulatory Reform Order

Commission review of NECA's proposal to adopt these existing incentive options within the NECA pools should require minimal Commission resources.

In addition, the Commission has already made sound public policy decisions upon which those programs are based. NECA's settlement options framework is consistent with access reform concepts and would not adversely impact access reform.

Furthermore, AT&T's assertion that the OIR model has an unproven track record for promoting EC efficiency is not relevant.²⁷ Notwithstanding the fact that the OIR plan has been thoroughly reviewed and adopted by the Commission, AT&T proposes that Pool Optional Incentives based on OIR be deferred. This would result in the Commission's identified benefits of incentive regulation options not being made available to pooling companies for an indeterminate time. Since the Commission has carefully constructed optional incentive plans for non-pooling companies, it is important to permit pooling companies to have the ability to participate in optional incentive regulation in order to preserve pool neutrality.²⁸

and Regulation of Small Telephone Companies, CC Docket No. 86-467, Report and Order, 2 FCC Rod 3811 (1987), as amended in Regulation of Small Telephone Companies, CC Docket No. 86-467, Order, 3 FCC Rod 5770 (1988).

²⁷ AT&T at 4.

²⁸ Numerous proceedings before the Commission have stressed the need for pool neutrality. See NECA Petition at note 33.

3. NECA's Profit Sharing Plan Satisfies the Commission's Goals For Incentive Regulation.

Both AT&T and MCI question whether NECA's proposed profit sharing plan will achieve the desired goals of incentive regulation.²⁹ These concerns are based on a misinterpretation of both the way NECA's Profit Sharing Plan works and the rationale behind its inter-incentive company profit sharing feature.

1. NECA's Profit Sharing Mechanism is Reasonable.

NECA's Profit Sharing Incentive Option satisfies the Commission's goals to provide substantial incentives for increased efficiency and benefit to access rate payers.

a. Incentive Benefits Correctly Flow to Interexchange Carriers.

MCI incorrectly asserts that profit sharing plan participants will be able to reap windfall profits.³⁰ To prevent this from occurring, MCI recommends an add-back modification to the settlement rate calculation, and required profit sharing with customers during the final two-year period.³¹

These modifications are unnecessary. NECA's Profit Sharing Incentive Option will require cash refunds of excess profits from

²⁹ AT&T at 5 and MCI at 5.

³⁰ MCI at 5.

³¹ *Id.* at 8-9. MCI also questions NECA's reference to Section 61.50 of the Commission's rules (47 C.F.R. § 61.50) for exogenous rule changes, and proposes instead that NECA's proposed rules refer to price cap regulation (47 C.F.R. § 61.45(d)) (*Id.* at 4-5). NECA's intent in referencing section 61.50 is to mirror the OIR model adopted by the Commission.

incentive pooling study areas. These refunds will either be paid directly to interexchange carriers or be used in future period rate reductions.³² Profit sharing is not treated as an exogenous adjustment to future settlement rates. Therefore, the add-back is unnecessary.

Since refunds of excess earnings are required for each two-year incentive settlement period, no special treatment is warranted for a final two-year period. Interexchange carriers will receive full benefits of excess earnings whether or not the exchange carrier elects to remain on the incentive option for additional periods. Interexchange carriers will also realize the lower rates in future periods resulting from lower cost levels produced by the efficiency incentives whether or not the EC remains on the incentive option.³³

b. Inter-incentive Company Profit Sharing is Equivalent to OIR Provisions and Properly Balances Risks and Rewards.

AT&T claims that inter-incentive company profit sharing fails to provide substantial incentives for increased efficiency.³⁴ MCI adds that this inter-incentive profit sharing will virtually

³² Under either of these approaches, excess profits will flow to interexchange carriers in future periods once the calculations are completed for a given incentive period.

³³ For example, to the extent cost efficiency incentives result in the deployment of more cost effective technology or multiple EC sharing/joint use of new technology, these efficiencies will continue in future periods and be reflected in access tariff rates regardless of the form of regulation under which the EC files its tariff.

³⁴ AT&T at 5.

guarantee a lower earnings threshold rate of return which is at odds with the intent of the OIR plan.³⁵ These arguments are without merit.

NECA's sharing mechanism is required to reproduce OIR profit sharing on an equivalent basis for pooling study areas. The inter-incentive company profit sharing simulates the type of profit sharing that goes on within a holding company under the OIR plan.³⁶ Within a holding company, profit sharing occurs among its study areas before the calculation of profit sharing with its customers. NECA's inter-incentive company profit sharing makes this sharing explicit among the pooling study areas opting for the plan. Pooling study areas, because of their size,³⁷ have higher than average year-to-year volatility in their cost and demand levels. Thus, simulating the profit sharing that occurs within holding companies outside of the pool is necessary to make this incentive option viable for pooling companies.

A further justification for inter-incentive company profit sharing under the pool plan is that participants in NECA's plan

³⁵ MCI at 5.

³⁶ See, e.g., §65.702(c) which states in part ". . . if the carrier has filed or concurred in access tariffs aggregating costs and rates for two or more study areas, the earnings will be determined for the aggregated study areas rather than for each study area separately." Thus, inter-study area profit sharing will effectively occur between holding company study areas under OIR prior to calculating profits at the tariff filing entity level. Similar inter-study area profit sharing also occurs on an even broader scale under price cap regulation.

³⁷ Over 90% of pooling study areas have fewer than 10,000 access lines.

cannot file for a mid-course "tariff" correction of their settlement rates as an OIR company can.³⁸ This sharing mechanism helps balance the risk of not having this option available.

AT&T's and NCI's arguments against NECA's Pool Profit Sharing Incentive Option also fail to consider the fact that there is no guaranteed rate of return for participating companies. As NECA explained in its Petition, Pool Profit Sharing incentive companies whose earnings are below the threshold of 75 basis points below the authorized rate of return will receive funds only to the extent they are available from earnings above the upper threshold of other profit sharing plan participants.³⁹ Thus, these companies are at risk not only of earning 75 basis points below authorized levels but potentially unlimited underearnings if there are no excess profits from other incentive companies.⁴⁰

There is also no connection between optional incentive pool profit sharing and total NECA pool performance. The revenue calculations for profit sharing are based on the pre-set, historically-based settlement rates. These rates are independent of the pool realized earnings. Pool performance, therefore, has no impact on profit sharing calculations for participating companies or the resulting profit sharing with interexchange carriers.

³⁸ NECA Petition at 4.

³⁹ See NECA Petition at 9. These are the same defined bounds as found in the OIR plan, 47 C.F.R. § 61.50(j).

⁴⁰ As previously noted, these companies do not have a mid-course tariff filing option. See SUPRA at 10.

2. NECA's Proposal Motivates Participants to Stimulate Access Demand.

AT&T states there is no explanation as to how access demand would be stimulated or how access ratepayers would benefit from NECA's settlement options.⁴¹ By widening the earnings retention zone for participants, NECA's Profit Sharing Plan will increase profit motivation. Profits under NECA's proposal, like OIR, can be enhanced both by reducing cost and by increasing demand. Participating companies will have more incentive to improve the quality of existing services, and to introduce new services to increase usage of their facilities. These actions will both stimulate access demand and benefit interexchange carriers.⁴²

3. NECA's Reliance on the Commission's OIR Plan Model Deters Companies From Improper Use of Regulatory Incentives.

AT&T's uneasiness that a company could game the system is unjustified.⁴³ As NECA described in its Petition, the Profit Sharing Plan uses the two, two-year commitment applicable to OIR to safeguard against this type of behavior. There is no reason to impose additional restrictions on NECA's Profit Sharing Plan.⁴⁴

⁴¹ AT&T at 5.

⁴² To the extent that incentive companies lower costs, they will drive down their future settlement rates, which, in turn, will be reflected in future tariff rates. If interexchange carriers pass these access savings to their customers, access demand is further stimulated.

⁴³ AT&T at 6.

⁴⁴ NCI also proposes to extend the Small Company commitment from one to two, two-year periods or, alternatively, to reset settlement formulas annually. Again, NECA has modeled its Pool Small Company Incentive Option after Section 61.39 of the

III. CONCLUSION

NECA's proposed rule revisions are an appropriate response to the Commission's encouragement to introduce optional incentive plans into the pooling process.⁴⁵ NECA pool members' participation in optional incentive plans would benefit ratepayers through increased efficiency incentives, and under one of the incentive plans, through profit sharing. Optionality of the plan would ensure individual pool members the ability to continue to choose cost pooling or average schedule status and is consistent with the Commission's objective of providing a continuum of regulatory alternatives.

NECA's reliance upon OIR and small company regulations as its models for optional pool regulatory incentives ensures regulatory symmetry, fairness, and efficiency. NECA's profit sharing plan satisfies the Commission's goals for incentive regulation while recognizing the characteristics of pooling study areas and their need for a proper balance of risk and reward in order to be able to participate in incentive options.

In addition, NECA proposals for streamlined procedures for new service offerings in the NECA tariff, and revenue-neutral pricing flexibility for the pools, similar to that available to participants in the OIR Plan, were strongly supported by commenters.

Commission's Rules (47 C.F.R. §61.39) and no legitimate purpose is served by adopting a longer commitment period for companies that choose to remain in the pool.


⁴⁵ Regulatory Reform Order at 4562.

NECA's pool incentive proposals meet the Commission's goal to extend incentive regulation options to small and mid-sized telephone companies. Both MCI's and AT&T's concerns are unfounded. NECA urges the Commission to adopt NECA's rule revisions as proposed.

Respectfully submitted,

NATIONAL EXCHANGE CARRIER
ASSOCIATION, INC.

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Its Attorney

January 3, 1994

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing Reply Comments were served this 3rd day of January, 1994, by mailing copies thereof by United States Mail, first class postage paid, to the person listed.

By 
Lisa L. Leibow

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